Economic Consequences of the New Iraqi Constitution

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Constitutions can play a critical role in founding and unifying new or renewing states: Iraq is no exception. A new constitution for post-Saddam Iraq can play a key role in reunifying and strengthening the national consciousness of the country. It can also lay the foundation for the creation of a viable dynamic economy. To many the constitution drafted and ratified in the summer of 2005 holds out this promise. To others, the ratified constitution contains too many flaws and inconsistencies to enable the country to escape from its current state of violence and economic stagnation. Even worse many contend[1] that unless a series of contentious issues surrounding the constitution and the events leading up to its drafting are resolved quickly, the integrity of Iraq as a unified state will be in question.

One of the main controversies surrounding the constitution is its federal nature. The 1990s and early 21st century have witnessed an increased interest in federalism as a viable system for conflict-prone societies, especially those in the developing world. Federalism has been promoted as an optimal arrangement for responding to ethnic diversity. Its main strengths lie in the fact that it grants internal self-determination to territorially concentrated groups; makes for institutional expression of pluralism; and enhances political participation, equality, accountability, and efficient and equitable provision of services.

Yet despite the potential advantages of a federal system, the debates in Iraq have become increasingly polarized.

Iraq is the latest country to consider adopting a federal system of government. Yet despite the potential advantages of a federal system, the debates in Iraq have become increasingly polarized. Sunni Arab delegates on the constitutional commission have accused the dominant Shia and Kurdish factions of seeking to force the constitution through, despite the lack of a consensus over some of its most sensitive elements.

A related issue is the manner in which the constitution treats the underlying causes of the "rentier state problem." It is widely posited that rentier states like Iraq which depend on one mineral resource like oil for 10 percent of GDP and/or 40 percent of export income (Iraq's values are much higher) are prone to militarization, civil war and economic instability. More to the point, resource abundance commonly leads to corruption, distributional inequalities, and economic mismanagement eventually fueling internal conflicts.

The sections below examine the new Iraqi constitution from the perspective of its potential economic consequences. In particular, the economic implications, both positive and negative, of the creation of a federalist state are assessed. The closely related issue of the constitution's treatment of oil resources and the possibility of Iraq circumventing the rentier state syndrome are also examined in some detail.

1 Main Economic Issues Addressed

Developed largely by the Shia and Kurdish blocs, the constitution adopts an extremely strong form of federalism. The result is a constitution that makes it both easy and attractive to form other multi-province regional governments. Each of these regional administrations can choose to wield greater legal and executive powers than the federal government.

The Constitution: General Economic Provisions

The detailed economic sections begin with Article 22. Many of the economic articles can be found in most modern-day constitutions. Several have direct bearing on the issue at hand:[2]

Article 22:

(1st) Work is a right for all Iraqis in a way that guarantees them a good life.

(2nd) The law regulates the relation between employees and employers on an economic basis, while keeping in consideration rules of social justice.

(3rd) the state guarantees the right to form or join syndicates or professional unions. This shall be regulated by law.

Article 23:

(1st) Private property is protected and the owner has the right to use it, exploit it, and benefit from it within the boundaries of the law.

(2nd) Property may not be taken away except for the public interest in exchange for fair compensation. This shall be regulated by law.

(3rd) (a) An Iraqi has the right to ownership anywhere in Iraq and no one else has the right to own real estate except what is exempted by law. (b) Ownership with the purpose of demographic changes is forbidden.

Article 24:

The State shall guarantee the freedom of movement for workers, goods and Iraqi capital between the regions and the provinces. This shall be regulated by law.

Article 25:

The state shall guarantee the reforming of the Iraqi economy according to modern economic bases, in a way that ensures complement investment of its resources, diversifying its sources and encouraging and developing the private sector.

Article 26:

The country shall guarantee the encouragement of investments in the different sectors. This shall be regulated by law.

Article 27:

(1st) public property is sacrosanct, and its protection is the duty of every citizen.

(2nd) Regulations pertaining to preserving and administrating state property, the conditions set for using it and the cases when giving up any of the property may be allowed shall be regulated by law.

Article 28:

(1st) Taxes and fees shall not be imposed amended, collected or eliminated except by law.

(2nd) Low income people should be exempted from taxes in a way that guarantees maintaining the minimum level necessary for a living. This shall be regulated by law.

Implications of the General Economic Provisions

Before examining the implication of the constitution's main economic provisions, a word of caution is in order.[3] The impact of a constitution on economic policy in particular and on economic performance in general is not simply a matter of the text itself. For one thing, constitutions can be written or unwritten. Some countries with a written constitution also have unwritten constitutional conventions. In the United States, for instance, the independence of the central bank (The Federal Reserve Board) is not explicitly stated in the constitution as it is in some others. Yet the board enjoys considerable de facto autonomy because an unwritten convention ensures that the executive and the legislature would incur costly political sanctions if they tried to interfere.

Second, constitutions can be effective or ineffective. The constitutions of the formerly communist countries played no role in regulating political life. In many countries today, the constitution is little more than a piece of paper.

Third, in countries with a constitutional tradition, the real constitution consists of the thousands of court decisions that have spelled out the abstract and general provisions of the original document and adjusted them to changing circumstances and problems that were unforeseen and unforeseeable at the time the constitutions were formulated.

In Iraq's case, there is another safeguard. In the days immediately before the election took place, the various factions—Shiites, Sunnis and Kurds agreed that the parliament to be elected in December 2005 will create a commission to review the constitution and propose amendments. In turn, these amendments will be submitted to yet another referendum six months later.[4]

With these caveats in mind, if implemented, the articles noted above would establish a modern, market driven economy.[5] In many ways, the constitution will result in a continuation of the controversial neoliberal economic reforms[6] introduced in late 2003. At that time, the Coalition Provisional Authority (CPA) enacted laws that: (a) give foreign investors equal rights with Iraqis in the domestic market; (b) permitted the full repatriation of profits; (c) instituted a flat tax system; (d) abolished tariffs; (e) enforced a strict intellectual property rights regime; (f) planned to sell off a whole range of state-owned companies; (g) prepared to reduce food and fuel subsidies; and (h) eventually privatize many social services such as health, education and water delivery.[7]

Whether the constitution's economic agenda is the best way to proceed at this time is certainly an open question. Debates in modern political philosophy are to a large extent organized around two polar positions. On the one hand, there is the view that societies ought to maximize some aggregate utility or wealth in the sense of dynamic growth over time rather than static allocative efficiency. On the other hand, there is the view (usually associated with John Rawls) that societies ought to assure the highest level of well-being for the worst-off members. The first view is often referred to as the efficiency-oriented and to the second as the security-oriented.[8]

The economic sections of the constitution agreed upon toward the end of August 2005 set a somewhat different tone than in earlier versions. As late as June 30, 2005, drafts of the constitution made repeated calls for "social justice" as the basis of building society. This emphasis was missing in later versions.

The Iraqis wanted, at least on paper, to build a Scandinavian-type welfare system in the Arabian desert with Iraq's vast oil wealth to be spent on upholding every Iraqi's right to education, health care, housing and other social services. "Social justice is the basis of building society," the draft declared. All of Iraq's natural resources would be owned collectively by the Iraqi people. Everyone would have the right to work and the state would be the Iraqi people's collective instrument for achieving development.[9]

In short, the writers of the constitution appear to have shifted from a security-oriented constitution to one more focused on attempting to achieve high levels of economic efficiency. It is not clear why the shift in emphasis occurred. One analyst feels[10] it was a result of US pressure. This interpretation is consistent with the observation of a Sunni negotiator who concluded: "This constitution was cooked up in an American kitchen, not an Iraqi one." [11]

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This shift in emphasis of the market over the state has a number of implications, especially if the country's poor economic performance continues. The rough picture we have at the present time is one of an economy that probably contracted by about 35 percent in 2003, recovering somewhat in 2004. At least 30 percent[12] of the labor force is unemployed with 60 percent depending on food rations to survive. A November 2004 survey[13] of 28,500 Iraqi families conducted by the government's Central Statistical Office (CSO) found the average monthly income of an Iraqi family was $127. Of those surveyed, only 15 percent had not completed elementary school, but just 9 percent had graduated from high school. Twenty percent of the respondents were illiterate.

While we still do not have a clear picture of the contemporary dynamics of the Iraqi economy, it is still safe to say that the country's economic health will be a key determinant of its long run stability.[14] Clearly, factors such as the lack of commercial credit[15] together with uncertainty due to the security situation have largely brought investment in the formal segments of the economy to a halt.[16] Yet, from anecdotal accounts,[17] there are indications that many areas of the shadow economy are prospering and, as during the period of sanctions, successfully adapting to the harsh environment.

In short, the Iraqi economy currently exists as a huge welfare state. The government is the country's leading employer, paying the wages of around half the country's workforce. Yet for budgetary reasons, there are plans to reduce the number on the state's payroll. The neoliberal reforms will only place further pressure on the government to scale back many of its job creating activities. As things stand, many government ministries can carry out their duties with only about 40-60 percent of employees.[18] Yet with little private sector investment, it is hard to see how the unemployment rate can be reduced significantly.

The logical area of job creation, the American- led reconstruction effort, has had only a minor effect on employment with at most around 150,000 Iraqis employed on such projects. The Ministry of Labor and Social Affairs (MLSA) has established a network of training and recruitment centers in

Iraq's major cities, but relatively few jobs have been found.

As of May 2005, the MLSA had found work for 115,000 Iraqis in the previous six months. Unfortunately, 110,000 people had applied for jobs in the MLSA centers in Baghdad alone in that time, and more than 600,000 had registered across the country.

Given its current financial situation, the Iraqi government cannot afford to employ more people. Certainly over time, the country's unemployment problems will have to be solved by the private sector. Unfortunately at this time, most private companies outside the construction sector are not in a position to significantly increase their hiring. In fact, many Iraqi companies are struggling just to compete after years of protectionism and severe shortages of key inputs such as capital and technology. The surge of imports under the government's free trade policies while helping to keep inflation rates down has placed a severe strain on existing companies while discouraging investment on the part of new firms.

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Instead of direct government action to create jobs, the constitution implicitly assumes that this will occur through privatization. In May 2005, Iraq's Ministry of Industry announced plans to privatize most of its 46 state-owned companies. The rationale underlying this decision was concern over the companies drain on the government's financial resources, in an attempt to reduce the financial burden on the state caused by the firm's large operating losses. Another rationale was that privatization will help attract both domestic and foreign investment thus expanding the demand for workers.

Both assumptions appear unrealistic given the security situation and the intense competition faced by most firms. In fact, there is considerable evidence that capital is flowing out of the country rather than into new productive activities. It has been estimated that by 2005 as much as $2 billion of capital had left Iraq following the overthrow of Saddam Hussein. Jordan has attracted a large share of these funds. Perhaps even direr for the country's long-run economic viability is the massive brain drain of young Iraqis from the country. Again Jordan is a prime destination for many of the country's most talented youth and successful businessmen.[19]

To sum up, Iraq's new constitution lays the beginnings of a foundation for moving ahead with the shock therapy economic program initiated by the Coalition Provisional Authority in 2003. Shock therapy is an apt term often used to describe the package of measures that transformed the economies of the former communist countries of Central and Eastern Europe from communist to capitalist. These measures were highly controversial, with many economists, especially the "new institutionalists" contending that a more gradual approach could guide the transition to a market economy while avoiding much of the dislocation associated with shock therapy's market driven, limited government approach.

To the new institutionalists, the experience of transition shows that the neoliberal policies of liberalization, stabilization and privatization that are not grounded in adequate institutions, may not deliver successful outcomes. Yet the constitution is silent on how and when the institutions needed to support the free market agenda are to be created.

The economic theories of federalism may provide some insights as to the manner in which this institutional development might proceed now that the constitution has been ratified. First Hayek,[20] suggested that, because local governments and consumers have better information than the national government about local conditions and preferences, they will make better decisions. Second, Tiebout[21] argued that competition among jurisdictions allows citizens to sort themselves and match their preferences with a particular menu of public goods. In this spirit, Musgrave[22] demonstrated how the appropriate assignment of jurisdictions over public goods and taxes can increase welfare. Finally, Qian and Weingast[23] show that political institutions serve a similar role for government officials as firm institutions do for firm managers. Appropriately designed institutions help align the interests of public officials with citizens, while federalism can help government officials to maintain the positive and negative incentives necessary for thriving markets.

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These theories of federalism, however, implicitly assume a fairly common set of economic systems across the various regions. For example, slightly different variants of free market capitalism across the various US states with some states having more state financed programs than others. In the Iraqi case, one can visualize a more diverse set of economic systems evolving in the three main regions. Elements of an Islamic economic system appeal to many Shiites and are one distinct possibility. The many Sunni, frustrated over the country's dire economic plight and the seeming inability of the government to restore a sound economy often allude to the economic successes of the 1970s under socialism and state planning.[24] The Kurds have prospered in a relatively free market so the constitution no doubt has wide appeal in that region. The Kurdistan Regional Government (KRG) is pro-Western, technocratic and investment friendly and Kurdish leaders want to exploit these features to attract western investment to the northern hydrocarbon sector.[25]

If a loose federation is agreed upon, it is easy to see the three major regions of Iraq adopting variants of these three somewhat different and potentially competing economic systems. Whether or not these systems will be able to coexist successfully is something the theoretical literature has yet to shed much light on. Would the likely more efficient Kurdish system prevail over the less productive? Given the availability of oil revenues and their possible allocations to the various regions, one can envision a number of outcomes where subsidies might enable the medium-term perpetuation of outcomes not commonly found in the developing world. As the theory of federations suggests, the potential might be there for an overall efficient economy. As in many countries however, the "oil curse" may produce an outcome far from ideal.[26]

Treatment of Oil in the Constitution

While important from the perspective of the country's economic recovery and eventual growth and development, the debates over the type of economic system to be adopted by Iraq have been rather low-key. Perhaps of all the articles in the constitution, those relating to oil have been the most contentious. The key provisions are outlined in Articles 109 and 110.[27]

Article 109

Oil and gas is the property of all the Iraqi people in all the regions and provinces.

Article 110

(1st) The federal government will administer oil and gas extracted from current fields in cooperation with the governments of the producing regions and provinces on condition that the revenues will be distributed fairly in a manner compatible with the demographical distribution all over the country. A quota should be defined for a specified time for affected regions that were deprived in an unfair way by the former regime or later on, in a way to ensure balanced development in different parts of the country. This should be regulated by law.

(2nd) The federal government and the governments of the producing regions and provinces together will draw up the necessary strategic policies to develop oil and gas wealth to bring the greatest benefit for the Iraqi people, relying on the most modern techniques, market principles and encouraging investment.

Article 110 clarifies that revenue-sharing will be based on needs as well as demography, reflecting the region's "duties and obligations, and taking into consideration the (region's) resources and needs.

The wording of Article 110 hints that exploration and development strategy will be undertaken in partnership with the regions. The wording of Article 109 does not exclude foreign ownership of upstream oil industry assets, though most senior oil officials are not in favor of this level of foreign investment. Presumably, the detail of hydrocarbon development policy will be left to national and regional legislatures. [28]

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The constitution's treatment of oil production and revenues present a number of unattractive scenarios to the Sunnis and it is easy to see why they have been quite opposed to the new charter. Specifically, they are concerned with the creation of a federal system where they are at a major financial disadvantage vis-à-vis the Kurds and Shiites. In this regard, the constitution defines a region as one or more provinces that choose by referendum to form a region. A referendum can be called fairly easily: either by one third of the members in the relevant provincial councils or by one-tenth of the voters in these provinces. Moreover, two or more regions have the right to create a single larger region. "Here the Sunni nightmare in plain black and white: The Kurds are allowed to form a single supra-region in the oil-rich north, the Shiites to form theirs in the oil-rich south, while the Sunnis are left in the oil-dry center."[29] Clearly, the Sunnis fear that the Kurds and Shiites will create their own super-regions which will dominate Iraqi politics and economics.

As noted above, Article 110 addresses the resulting inequities by declaring that revenue from oil and gas extraction will be fairly distributed through the country according to need. However this section, Article 110, refers only to revenue from current oil and gas fields not from the vast untapped wells. Sunnis fear they will see little revenue derived from new wells brought on line in the future. As the constitution stands, the regional states are delegated authority over all new fields and therefore control over the negotiation of exploration contracts and the bulk of revenues derived from future production.

Article 110 suggests that the Sunni areas could be disadvantaged for some time on grounds that the Shia south and Kurdish north suffered chronic underdevelopment during the Saddam era. The exact formula for revenue-sharing will be fluid and shaped by Iraq's national parliament where the Sunnis are likely to be a distinct minority.

The Kurdish government concluded at least three production-sharing agreements with Turkish and Norwegian companies in the last few years that cover several fields in the Kurdish areas. Those deals were done independent of the Iraqi oil ministry. At the same time, Baghdad did not recognize those agreements and warned companies against signing such agreements. With the new constitution, such agreements would now become legal.[30]

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While turning a de facto situation in Kurdistan into a legitimate state, the implications for the rest of Iraq are more significant. Iraqi oil experts warn that while the role of the federal government in oil matters has been marginalized, the powers of the Shiite oil-producing region in the south are more likely to grow. At the moment, there are two producing governorates in the south, Basrah and Missan. However, other governorates have non-exploited oil fields such as Nasiriyah, which contains the Gharraf oil field. According to the constitution, those governorates can set up regions and become semi-autonomous like the region of Kurdistan.[31]

Related concerns have been expressed by a number of knowledgeable oil executives and industry analysts. The main concern is that the constitution as worded could lead to several autonomous zones under which a central government in Baghdad would not have complete control over oil resources:[32]

> Unless there is some central control, like a national oil company, there is going to be chaos, especially if preference is given to regional laws that would override federal laws.
>
> **Muhammad-Al Zainy, senior energy economic analyst, Center for Global Energy Studies, London**

> I am against federalism, it will not be good for the oil sector. It will only put it back instead of developing it.
>
> **Shamkhi Faraj, director-general, Economics and Oil Marketing**

> The governorates are hardly able to take care of their local affairs let alone run an industry and negotiate contracts. I am certain that oil companies have been taken aback by this.
>
> **Saadallah Al-Fathi, former senior Iraqi oil official**

> The constitution does not have a clear, detailed or mature vision about the issue of oil. This is a recipe for chaos. We will not only lose central decision making in the process but also the question of legislation. Companies will face huge legal problems. If they sign with a political entity, their contract may not be protected in the long term.
>
> **Mustafa Alani, Gulf Research Center**

Optimists say in the longer term, the decentralized government could lead to a faster development of Iraq's oil and gas fields. However, Sunni dissatisfaction with the constitution could agitate the insurgency further and keep foreign investments at bay. In that case, only the Kurdish region, which has been spared the security problems characteristic of the rest of Iraq would be able to attract foreign companies to invest in developing its oil and gas fields.[33]

A good case can be made that the constitution's treatment of the ownership and distribution of oil resources and revenues has the potential in the context of a federalist state organization to contribute to the country's economic instability. By not separating the state from oil i.e. the direct link whereby oil revenues accrue directly to central and regional governments, the constitution has left in place a mechanism that has more often than not led to full rentier state development. Rentier states can potentially have more problematic relations with society, having lesser need to negotiate taxation terms with social elites, potentially leveling class distinctions and thereby making ethnic and religious differences more significant, and creating a rentier class that is disconnected from social and political constraints. The result has been an all too common set of outcomes in oil-producing developing countries:[34]

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1. Economic growth has been comparatively slower in most resource-dependent countries since the 1970s; a pattern that also affected most oil exporters after the end of the oil boom in the mid-1980s.

2. Resource dependence has been associated with poor governance, high levels of corruption and (often incompetent) authoritarianism. Governments in resource dependent countries tend to be more corrupt as a result of the discretionary control of large rents generated by resource exploitation.

3. Oil-producing states also often exhibit extreme levels of institutional conservatism and inertia, with government stability relying on fiscal transfer rather than statecraft.

4. Many resource-rich governments prioritize security spending, while oil exporting countries in particular face a higher risk of armed conflict.

5. Extremely high levels of resource revenues like Iraq's have allowed governments to maintain stable autocracies by buying social peace, co-opting political opponents and funding effective security agencies.

6. In most cases, however, a concentration of power by factionalized ruling elites, poor governmental legitimacy, as well as foreign vested interests presents major challenges to peace in resource-dependent countries.

7. The consequences of the "resource curse" for the population are often paradoxical as it finds itself "hostage" to an omnipotent state, source of both hope and frustration when facing conditions of poverty, inequalities, and human rights abuses.

Although the state may pursue populist policies by redistributing resource wealth, the state is ultimately insulated from the population through the independent tax base that the resource wealth provides. Many Iraqis fear that future oil revenues will be squandered in the midst of a culture of corruption and favoritism reminiscent of Saddam Hussein's regime.

While it is not clear that a constitution is necessarily the best place to address these issues in any sort of detail, no doubt many observers would have felt more comfortable if the drafters had expressed a general commitment to follow through on institutions capable of combating or keeping in check many of the rentier state excesses. Here the biggest problem may be one of perception on the part of Iraqis themselves. As one recent visitor to Iraq observed:[35]

A serious problem among both intellectuals and the public at large is the mistaken perception that because "Iraq is a rich country," all they need is "the right leadership" to be able to divide up the oil resources properly. The course of oil has had a pernicious effect on the economy, on politics, and on intellectual life.

Furthermore, the constitution leaves open the possibility of abuse of economic power by the Kurds and Shiites.

Summing up, the constitution's sections on oil appear to satisfy Kurdish and Shiite concerns and needs, but not those of the Sunnis. Furthermore, the constitution leaves open the possibility of abuse of economic power by the Kurds and Shiites. The constitution's lack of clarity on many oil issues such as production and distribution are also conducive to an atmosphere of corruption and the creation of a failed rentier state.

Clearly, the Iraqi case has a number of unique aspects. However, before passing final judgment of the constitution's treatment of oil, the experience of other oil-producing federal countries may shed further insights as to the type of problems Iraq's constitution may create.

2 Lessons from Other Countries

Oil-producing countries have arrived at a number of methods for disbursing oil revenues. Conceptually these fall into two general categories – the methods adopted by unitary (centralized governments) and those implemented in federal settings (Figure 1). As one might imagine, the federal countries have had a more difficult time grappling with the problem of arriving at mutually agreeable sharing formulas. Perhaps because of their more decentralized expenditure patterns, macroeconomic stability has been a fairly wide-spread problem plaguing federal countries.

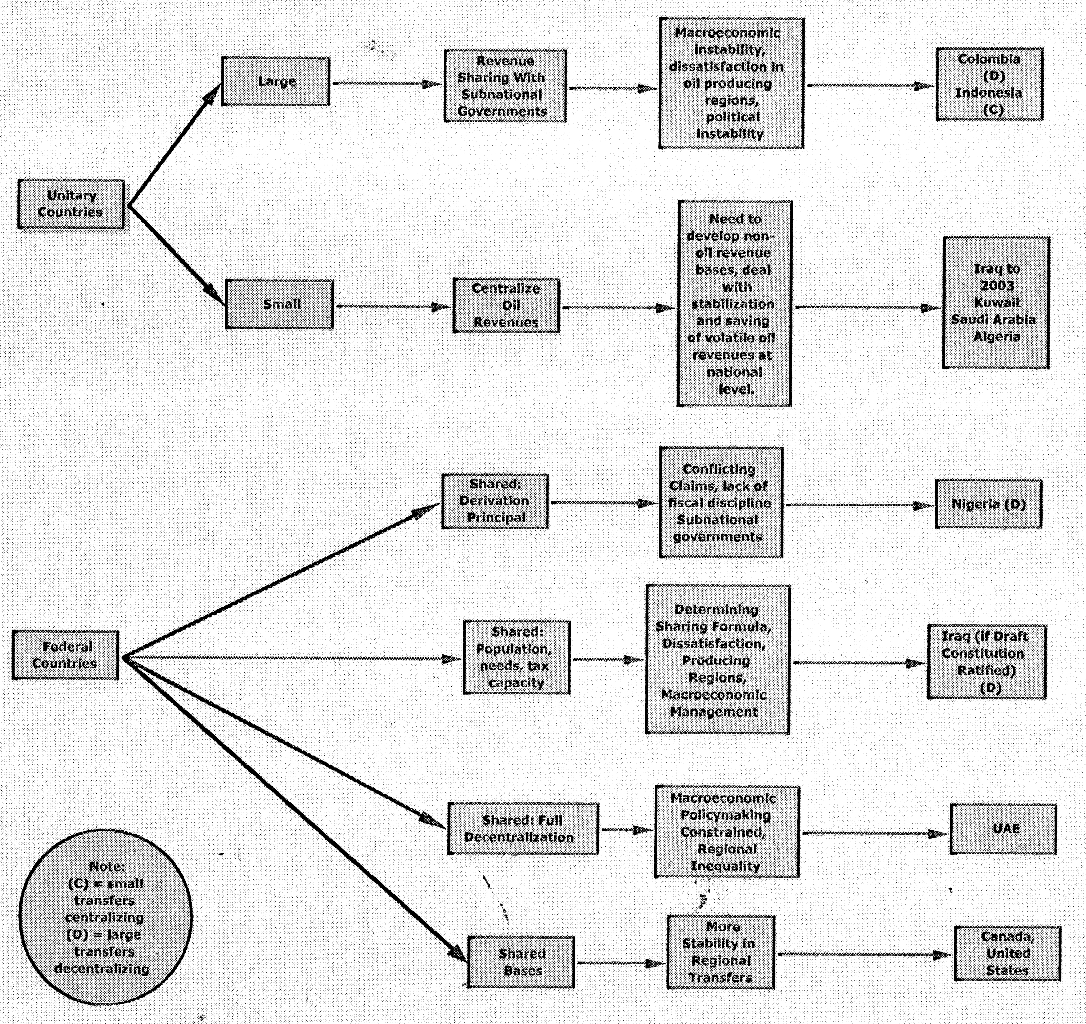
Of the major oil-producing countries, the Nigerian experience[36] might provide the best insights for Iraqi oil policy at this point in time. Nigeria is a federal state. As with Iraq, oil is the main source of revenue – 82 percent of the total revenue of the general government, or 40 percent of GDP in 2000.

Revenue Transfer Mechanisms in Nigeria

In theory, the mechanism of revenue transfer is straightforward and a formal process set up to distribute funds. After so called first charges[37] are withheld, oil revenue is shared between the federal government and the state/local governments according to an arrangement whereby the remainder (over 75 percent of gross oil revenue) is divided between the central government and subnational governments. More specifically, the 1999 constitution assigns the control and collection of oil revenue to the federal government but attributes at least 13 percent of the net oil revenue to the oil-producing states. In addition, about half of the net proceeds (after deduction of first charges) are redistributed to state and local governments according to a formula decided by parliament every five years. Excess proceeds over the budgeted revenue are also redistributed in the same way after assigning 13 percent to oil-producing states.[38]

Nigerian states and local governments are highly dependent on revenue-sharing arrangements with the federal government. In 1999, 75 percent of state revenue came from redistributed revenue from the federal government, including their share

Figure 1
Patterns of Oil Revenue Disbursement



of the VAT (85 percent of total proceeds), and 94 percent for local government revenue. Most of this revenue was oil related. Federation revenue released to subnational governments rose from 7.4 percent of GDP in 1999 to about 15.3 percent of GDP in 2001.

The two key challenges posed by the Nigerian model of fiscal federalism are the conflicting claims over oil resources and the lack of fiscal discipline of subnational governments. As sharing arrangements for oil revenue combine the derivation and the distribution principles, they remain highly contentious. Given large disparities in natural resource endowments, oil is concentrated in only a few of the 36 states, which have onshore or offshore oil production.

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Several of the main oil-producing states have called for total regional control over oil revenues. Other oil states have claimed that the 13 percent share accruing to oil-producing states should also be applied to oil revenue from offshore production (which represents about 40 percent of oil revenue). Not happy with the manner in which their claims have been considered, the oil-producing states have in effect simply refused to turn over the stipulated share of oil revenues to the central government.[39]

Lessons for Iraq

Even Nigeria's relatively sophisticated revenue sharing agreement has led to severe political problems with the oil-producing states demanding and often just taking an increasing share of oil revenues. There is no reason to believe the allocation mechanisms system evolving out of the constitution would fair any better.[40] In fact, a strong case can be made that given the country's ethnic make-up and geographic distribution of oil reserves, a future Iraqi federation would experience many of the problems currently plaguing Nigeria.

In Nigeria's case, there is a legal mechanism to impose fiscal discipline on the lower tiers of government. The high oil prices in recent years have led to a large increase in the distribution of financial resources to subnational governments, particularly to oil-producing states, without the corresponding assignment of new expenditure responsibilities. The resulting increase in aggregate demand has led to a rapid increase in aggregate demand and money supply, leading to inflation and a sharp depreciation of the currency in the parallel market.

The revenue sharing arrangement leaves virtually no room for maneuver on the fiscal side. It places the burden of macroeconomic adjustment on the federal government with control over less than half of the federation revenue.

Ideally, financial resources to state and local governments should be insulated from oil price fluctuations, and commensurate with the tasks that they are assigned to perform and their capacity to effectively spend such resources. This would imply a shift from a transfer system which relies on the sharing of volatile natural resource revenues to one that provides for stable financing of the provision of at least a minimum set of essential subnational public services.

Unless these safeguards are somehow incorporated into law or through a modification of the constitution, one can easily visualize the proposed oil sharing arrangements in Iraq leading to increased macroeconomic instability, regional tensions, and resentment, and overall poor economic performance and even a collapse of the system.

Assessment

A cursory reading of the post election press reports suggests more dire predictions than those. The common themes stressed by the pessimists include the observations to the effect that:[41]

1. The constitutional process is not a sign of Iraqi sovereignty and democracy taking hold, but rather a consolidation of US influence and control. The constitution is likely to make the situation in Iraq worse.

2. The ratification process reflects US, not Iraqi urgency. It resulted in a vote in which most Iraqis did not even see the draft. Amendments were being reopened and negotiated by political parties and elites in Baghdad as late as days before the referendum.

3. The constitution will strip Iraqis of future control over their nation's oil wealth by opening all new oil exploration and production to foreign oil companies.

4. The imposition of federalism as defined in the draft constitution undermines Iraqi national consciousness and sets the state for a potential division of Iraq largely along ethnic and religious lines, with financial, military, and political power devolving from the central government to the regional authorities. All groups risk sectoral as well as national interests.

5. Human rights, including women's rights, individual political and civil rights, economic and social rights, religious rights, minority rights, all remain at risk.

6. Instead of balancing the interests of Iraq's diverse population by referencing its long dominant secular approaches, the draft constitution reflects, privileges and makes permanent the current occupation-fueled turn towards Islamic identity.

There may be an element of truth to some of these points. However, the sections above suggest a more fundamental cause of concern – the manner in which oil revenues and production will be controlled by the regional authorities.

On a theoretical level, federalism is predicated on meeting two, seemingly irreconcilable goals: it seeks to unify diverse, often hostile localities under a single national banner, while allowing considerable authority to remain at the local level. When practiced well, a federal system successfully reconciles the two demands, proving citizens with the simultaneous benefits of the protection of local specific rights, and the wider advantages of economies of scale and security allowed for by a larger national body.[42]

However, many of the case studies of federalist countries, especially in the developing world, stress the system's limitations: federalism threatens macroeconomic stability, institutionalizes discriminatory treatment of citizens, causes competition among groups, and encourages the latter to ask for more powers, which often leads to separation. In fact, the system has not performed well in the developing world. In Asia, Indonesia and Pakistan went federal at various times after independence, but quickly deserted it, while the Malaysian federation led to the exit of Singapore in 1965. In Africa, Kenya and Uganda adopted the system after independence but soon abandoned it too. In the case of Uganda, it directly resulted in the political instability of the late 1960s and the civil war that ensued in the next decade.

The sections above have identified a similar set of potential problems that might arise now that the Iraqi constitution has been approved. One thing history tells us is that unless it is structured skillfully, any federal system will find it difficult to maintain an appropriate balance between local and central power. It is safe to conclude that the economic sections of the constitution will create an environment in which it will be very difficult to maintain this balance.

With oil revenue assignment shifting more toward the producing regions, the ability and perhaps willingness of local governments to pursue independent policies will increase with time – the likelihood of adverse rentier effects may increase with oil revenues concentrated in the hands of the regional governments. In this environment it is easy to visualize a vicious circle setting in (Figure 2) whereby the distributive formulas embedded in the constitution skew policy making decisions towards an over-reliance on oil revenues, leading to poor economic outcomes which in turn skew policy preferences more toward short run distributive rather than efficiency outcomes.

One option that has received surprisingly little attention is the simple one of distributing a relatively large share of oil revenues directly to the population. A clear advantage of this approach is that it would give the Sunnis a clear stake in the success of the economy.

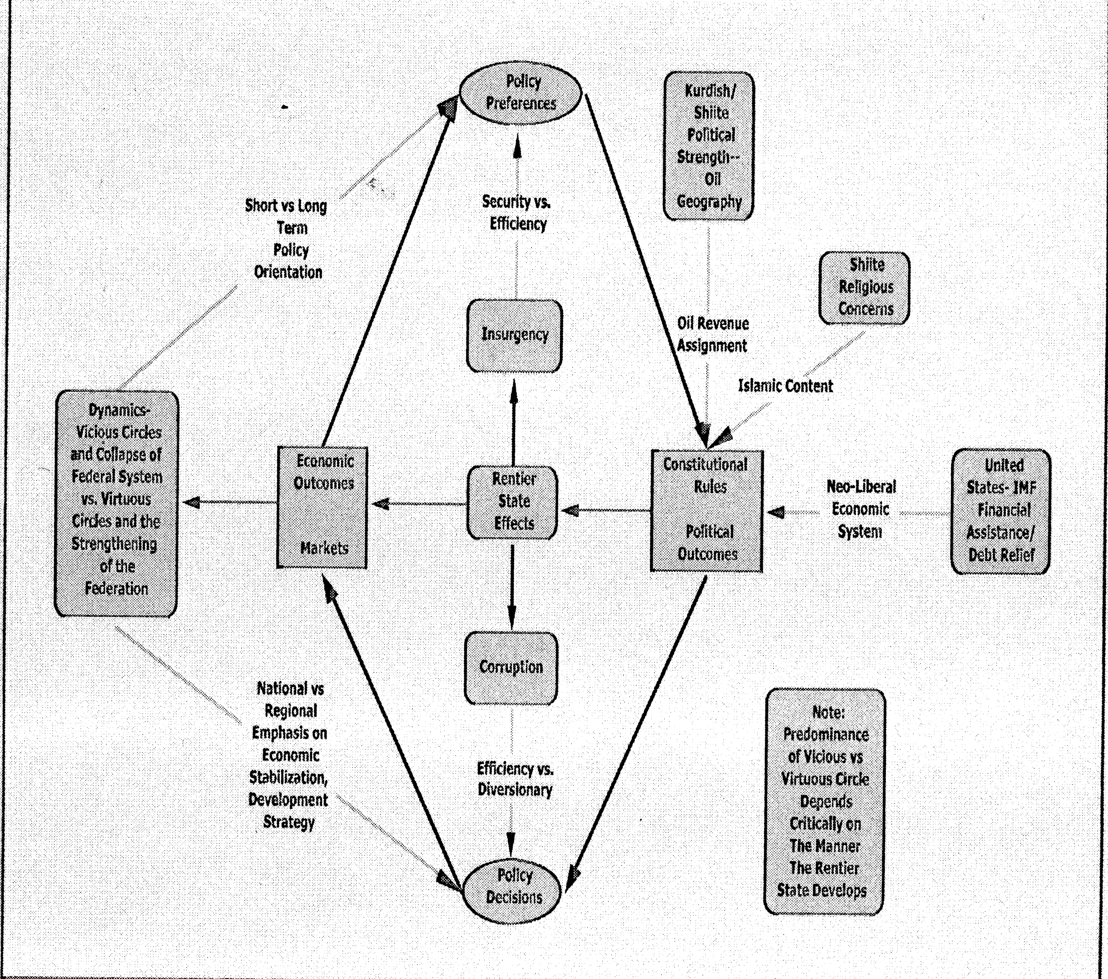
If rentier state effects subsequently strengthen, corruption and a more active insurgency are likely to reinforce the process of economic decline. On the other hand, if rentier state effects can be controlled or weakened than economic outcomes improve and with it the possibility of establishing a virtuous circle strengthening the federation and with increased political stability, thus leading to further gains in economic activity. This longer term virtuous circle can be further strengthened if stability results in a reorientation of economic policies from short to longer term focus with stabilization funds providing a supporting macroeconomic environment.

As noted above, before the referendum the constitution drafters added a last minute mechanism to review and amend the constitution in the first half of 2006. Because of their boycott of the elections in early 2005 and subsequent under-representation in drafting of the constitution, the Sunnis should have considerably more input in the amendment process. Hopefully, the next government with larger Sunni participation will see a more evenly balanced debate concerning the economic challenges facing the country.

There are some encouraging signs. For the southern provinces, interviews of voters suggest that the critical issue is to ensure that the proceeds of Iraq's oil exports are distributed more fairly than in the past – something that is explicitly catered for in the constitution. The impulse towards creating a virtual separate state is not as strong in the south as it is in the Kurdish north. Southern voters, for the most part, seemed to view the constitution as a vital step towards peace and stability, rather than as a divisive, provocative formula for Shia-Kurdish collaboration to suppress the once dominant Sunni Arab minority.[43] Although the Sunnis opposed the decentralization structure of the new constitution, their opposition centers more on the potential loss of oil revenues to the Kurds and Shi'a and less on regaining control of the entire country.[44]

What might the new government with increased Sunni participation want to consider in the way of modifying the economic sections of the existing

Figure 2
Iraq: Constitutional Rules and Economic Performance



constitution? One option that has received surprisingly little attention is the simple one of distributing a relatively large share of oil revenues directly to the population. A clear advantage of this approach is that it would give the Sunnis a clear stake in the success of the economy. Acts of insurgency that would jeopardize oil revenues would directly hurt large segments of the Sunni community. Formalization of this type of distributive system would allay Sunni fears that sometime in the future they would be completely cut off from the country's oil revenues.

A number of other benefits would also flow from the direct disbursement policy. With direct payments, massive subsidies and price controls would no longer be needed and could be quickly phased out, leaving prices to be determined by market forces. The broad-based demand that would be created from increased purchasing power no doubt would provide the opportunity for more profitable small-scale private sector businesses. Many studies of small- and medium-sized (SMEs) businesses in developing countries have concluded that businesses of this type are the chief engines of job creation and innovative activity.

As the experience of the transition countries of Central and Eastern Europe has shown, in addition to job creation and innovation, growing business sectors often find it in their best interest to press governments for additional market reforms. Governments, in turn, find it is in their interest to nurture this new base of prosperity and respond accordingly. In this way, it is conceivable that a virtuous circle of growth, reform, and further growth could be put in place over time in Iraq. The country has the broad-based talent, skills, and ingenuity to prosper if it can only break the link between state and oil, with its corrupting and debilitating influence.

Endnotes

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